purchasers of syndicable programming. The relevant question, therefore, is: "What are the relative expected values of the back-end rights to the same series if that series is carried initially on a network (including Fox), on cable or on first-run syndication?" To the extent that the expected values of the back-end rights to non-network programs are systematically and significantly less than the expected values of the back-end rights to network programs, the existence of the non-network alternatives for original programming cannot be relied upon to constrain network monopsony power in the market for syndicable programming.

33. Under the Merger Guidelines, "significantly less" would be defined as 5% or more. Our estimates, which are derived from discussions with knowledgeable industry participants and are consistent with the conventional wisdom in the industry, indicate that the syndication value if the first appearance is on cable is only about 20% of what the syndication value would be if the series first appears on a network, while only a handful of programs produced for first-run syndication have any repeat value at all. See also Attachment C. By a wide margin, therefore, using the Merger Guidelines methodology, the three networks and Fox are the only effective purchasers in this market.2/

2/ There is a another market in which the networks currently participate. This is the market in which the three networks, Fox, cable and perhaps even other suppliers distribute or sell programming or other entertainment directly (or via network affiliates) to viewers or advertisers. The networks argue that their market share and market power in this market have (Footnote 2 Continued)

34. Including all three networks and Fox in the market is appropriate, however, only in the context of potential or <u>ex ante</u> competition -- <u>i.e.</u>, competition among the networks at the time that a producer decides which network to approach with the idea for a new program. But back-end rights are virtually worthless until a network has committed to schedule a program, and by then the producer has long since locked himself in to that network and has foregone any access to any other network. Indeed, if at that point the network can condition access to its network on the acquisition of the back-end rights to the series, not only is there is no other actual or potential competing purchaser for these back-end rights, but even the option of simply retaining these rights is no longer available to the producer. This is why, contrary to the networks' and Seventh Circuit's suggestion, program producers are better off if the networks are prohibited from acquiring back-end rights in programs. <u>See also</u> Attachment C.

(Footnote 2 Continued)
declined significantly in recent years. The degree of network market power in this market, however, is completely irrelevant, since the FISR does not, and never has, constrained the exercise of network market power in the supply of network programming or other entertainment to viewers or advertisers. The extensive discussions of declining network share in this market in the networks' comments are thus a pure red herring in the context of the FISR. In brief, market power in the sale of the final product is not a necessary condition for monopsony power over inputs: a textile mill in a company town could monopsonize its workers even though it sold a homogeneous product in a world market; a aluminum smelter with a trivial share of the world market for aluminum could monopsonize local electricity suppliers, etc.

35. This is not an unusual problem in economics.3/ In many situations, there are large numbers of potential buyers *ex ante* -- *i.e.*, before the seller must make any significant contractual or financial commitments to a particular buyer. Over time, however, regardless of how many alternatives the supplier faced *ex ante*, as he incurs sunk costs or commitments that are specific to one buyer, that supplier becomes locked in to that buyer. Moreover, waiting to negotiate terms *ex post*, -- *i.e.*, after lock-in -- can harm the seller even when the seller faces only one buyer both *ex ante* and *ex post* since his reservation price -- and hence his bargaining position -- declines as those sunk costs are incurred.

36. In some cases, a seller can guard against *ex post* opportunistic behavior by the buyer by entering into a contract *ex ante*, *i.e.*, while competitive alternatives are still available and before any sunk costs have been incurred. Alternatively, a seller may expect that the buyer will refrain from exploiting its *ex post* market power because a reputation for opportunistic behavior would harm that buyer in future negotiations with suppliers not yet locked in to that buyer.

37. If there were enough networks competing *ex ante*, of course, eventually one or more would find it in its interest to make credible commitments to not take advantage of its *ex post* market power in the absence of the FISR. For example, a

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3/ O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: The Free Press, 1975) at chapter 2.

maverick network could attract new producers or repeat business by committing not to bid on or purchase the back-end rights to programs on its network, in much the same way as the AAA diagnostic service guards against even the appearance of conflicts of interest by committing not to perform any recommended repairs. The conditions imposed on the networks by the original FISR would, in short, become imposed on the networks by the market.

38. Today, however, there are only three (at best, four) networks. Given the public nature of any commitment by a network not to bid on or purchase back-end rights, each network would expect that such a move would force all the other networks to follow suit; no network could expect to remain for long in the enviable position of being the only network that committed not to exploit its locked-in producers. The choice facing each network would thus be between all networks exercising their market power ex post or all networks committing not to do so, making the exercise of market power both the individual profit-maximizing alternative for each network and the profit-maximizing alternative for the networks as a group. Indeed, prior to the FISR, program producers found that neither contractual provisions nor reputational effects were effective in deterring networks from exploiting their ex post monopsony power. And the producers firmly believe that the networks would exercise this power fully if the FISR were repealed.

C. The Role of the Original FISR in Preventing the Networks' Exercise of Market Power in the Market for Syndicable Programming

39. For these reasons, the goal of the network monopsonist is to engage in what program producers (and the FCC) refer to as "extraction" and what economists refer to as "first-degree price discrimination" -- i.e., setting the price paid for the network rights to each individual series (or, absent the FISR, for the package of network and back-end rights), as close as possible to that producer's "reservation price," the minimum price acceptable to the producer.4/ This is possible because network and back-end rights in programs are not homogeneous commodities, like wheat or pork bellies, that are sold in commodity markets where a single price prevails for all units at any one time. Instead, individual prices for the

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4/ F. Scherer and D. Ross, Industrial Market Structure and Economic Performance (Boston: Houghton Mifflin Company, 1990) at chapter 13. Contrary to the network's economist's assertion, therefore, it is not true that "monopsony power, if it exists, can be exerted only by reducing the number or quality of programs purchased." Robert W. Crandall, The Economic Case Against the FCC's Television Network Financial Interest and Syndication Rules at 9. This would be the case only if the network had to pay the same price for the network rights to all series (or, absent the FISR, for the combined network and syndication rights to all series). If that were the case, since the reservation prices for network rights (or for the package of network and syndication rights) vary widely across series, any network, in attempting to lower its single price down toward the reservation price for some series, could not avoid setting a price below the reservation price for some other series, thus reducing the number or quality of programs purchased. If the prices for the rights to each series can be negotiated separately, however, as in the case of network and syndication rights, there is no need for a network to forego such a profitable opportunity: it can lower the price for the rights to one series without having to reduce the price for the rights to some other series to the point that the producer of that series will abandon the project.

network rights to each series are negotiated separately between the producer and the network in a one-on-one setting.

40. By the time that negotiations begin for the network rights (and, absent the FISR, for the back-end rights), the producer's only alternative to selling his program to the network is to abandon the project entirely. Absent the FISR, therefore, the producer's "reservation price" for the package of both the network rights and back-end rights is the total production cost for that program. Except insofar as it may be desirable to preserve producer cooperation on this series and perhaps goodwill for future series, the network would need to pay no more than this cost of production. Yet, in a competitive market, the combined value of the network and back-end rights to a syndicable program will exceed the cost of production, and hence the producer's reservation price, for every program except the "marginal" program, and often by a very large amount. The FISR is important to producers and the networks because it affects just where in that range (from the cost of production at one end, to the value that a competitive market would place on those rights at the other end) that the negotiated price of those rights will fall.

41. The networks argue that their ability to pay a price less than the competitive market price for program rights flows not from "market power," but rather from their superior "bargaining power." The Justice Department has suggested a similar distinction, telling the Commission that the FISR affects "the distribution of quasi-rents between producers and

networks." Reply Comments of the Department of Justice (October 5, 1990) at 35.

42. These are semantic, not substantive distinctions. What the networks and the Justice Department are describing is the exercise of market power. In a competitive market, many buyers will pay less than the maximum amount they would be willing to pay for a product or service. The difference between what buyers as a group would be willing to pay for the product and what they actually pay for that product is called "consumer surplus." Similarly, "producer surplus" is the difference between what producers' would be willing to sell their products for (i.e., their cost of production including a normal return on any investment) and what they actually sell their products for. Thus, for example, if the price of a bushel of wheat in a competitive market is $2, the bushel will be sold for $2 even though a farmer would be willing to sell it for $1 and a baker would be willing to pay $3. In these circumstances, there is $1 of producer surplus and $1 of consumer surplus. In a competitive market, producer surplus is not "shared" or "distributed" between producers and purchasers. The only way purchasers capture producer surplus for themselves is through the exercise of monopsony power.

43. Thus, when the networks and the Justice Department argue that the FISR prevents them from bidding down the price of programs to the program producers' cost, they are acknowledging that the networks have the ability to exercise monopsony power. Calling this power "bargaining power," or

calling the capture of producer surplus "the [re]distribution of quasi-rents," does not change this fundamental economic fact.

44. In defense of the Justice Department, it may have believed that even if eliminating the FISR facilitated first-degree price discrimination by the networks against producers, the effect would be to reduce the earnings only of "successful" or "established" producers without discouraging the entry of new producers or reducing the equilibrium stock of producers. But the usual efficiency (though not equity) defense of first-degree price discrimination under certainty (i.e., that it results just in a transfer of wealth and does not affect output) does not apply in this case. As discussed below, given that potential producers do not know with certainty how successful they will be in their career as a producer and that entry involves some sunk costs, the entrant's best estimate (absent special information as to his prospects) of his likely future earnings is the average earnings of current producers. Thus first-degree price discrimination by networks against producers ex post reduces the expected return to producers ex ante, and acts as a deterrent or barrier to entry, reducing the rate of entry and the equilibrium level of producers. Only in the very short run would even costless5/ first-degree price discrimination not reduce output.

5/ First-degree price discrimination may impose significant transactions costs or other inefficiencies. As noted above, if the network cannot accurately estimate future production costs, or if the producer refuses to accept that estimate, the network (Footnote 5 Continued)

45. The networks argue that allowing them to bid on back-end rights would just add three more bidders for those rights, and thereby benefit the producers by increasing competition. Indeed, the networks assert that the original FISR necessarily reduced the number of competitors in the business of financing television program production. But, as the producers fully understand, allowing the networks to regain the ability to condition network access on their acquisition of back-end rights will not increase the number of bidders. Rather, it will reduce to one the number of bidders available at the time that the contract terms are actually negotiated.

46. Under the original FISR, the producer could retain the back-end rights (i.e., "self-finance") or sell all or some fraction of those rights to a number of potential buyers: at the very least, the producer could keep the rights if he values those rights more than do third parties. Absent any rules, however, the number of potential bidders ex ante would be at best three or four networks. Even ex ante, the option of simply retaining back-end rights would be lost -- a

(Footnote 5 Continued)
can simply offer to compensate the producer for his actual production costs -- i.e., offer him a cost-plus contract. But shifting to a cost-plus contract reduces or even reverses a producer's incentives to control costs and necessitates closer monitoring of the producer by the network. In addition, eliminating the producer's financial stake in the program that had been provided by his ownership of the syndication rights reduces producer initiative and incentives to increase quality. Even if much of the cost of such inefficiencies would ultimately be born by the networks, however, moving closer to first-degree price discriminatory pricing structure will still be profitable if the transfer from the producers exceed the cost of inefficiencies born by the networks.

producer could be forced to sell those rights to a network even if the price is far less than the price at which he would choose to self-finance. And ex post (i.e., once the program has progressed beyond infancy and the producer is locked in to a single network), the producer is faced with only one bidder. Again, he does not even have the option of simply retaining those rights himself. If he refuses to sell the rights, after all, the network can refuse to commission a pilot.6/

47. The networks have long argued that even with the FISR in place, any network can already fully exploit its monopsony power simply by setting the network fee for each program at the level that will leave the producer with no more than the bare minimum required to induce him to stay in

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6/ The networks' "tying" of the purchase of the back-end rights to the purchase of the network rights can be almost indiscernible: it does not have to be "forced" or even explicit. Consider the following example: Suppose that the economic cost of a program (i.e., including a normal return on investment, the opportunity cost of the producer's time, etc.) is $500,000. Suppose further that, if sold separately, the network rights would sell for $500,000 and the back-end rights for $100,000. Because a producer is locked-in to a network by the time the back-end rights are sold, the network knows that it can drop its network fee to $400,000, and "offer" to purchase the back-end rights for $200,000. Indeed, as argued below, if elimination of the FISR allows a network to set a price closer to the producer's reservation price, the network can drop its network fee to $300,000, and offer to purchase the back-end rights for $200,000. Eliminating the FISR would thus allow the network to acquire network rights that are worth $500,000 and back-end rights that are worth $100,000 for only $500,000 -- i.e., to acquire the back-end rights for free (something that the producers have always alleged and the networks have argued is an economic impossibility). To succeed, the network need only be sure that the combined price equals or exceeds the producer's cost, and that the network's offer for the back-end rights exceeds the stand-alone competitive price.

operation. In theory, with perfect information, the network could do this by setting a network fee that is exactly equal to the cost of production minus the value that the producer places on the back-end rights (i.e., the producer's "reservation price" for the network rights). The producer's deficit would then just equal the value of the back-end rights anticipated at the time the network fee was negotiated. And the network would have captured, through a lower network fee, all of the difference between the total cost and the total value of a syndicable program.

48. The original FISR, however, significantly impeded the ability of a network to engage in this conduct -- i.e., to act as a first-degree price-discriminating monopsonist. A network's ability to engage successfully in extraction through price discrimination depends critically on how accurately it can estimate the producer's reservation price for program rights. Just as in bargaining between a customer and a salesman over the price of a car, knowledge of the other side's reservation price is a valuable asset that can significantly affect the price that is eventually arrived at, especially if bargaining power is one-sided.

49. The original FISR, by prohibiting the networks from owning back-end rights, forced the network to negotiate for the network rights alone rather than for the network and back-end rights as a package. But estimating the producer's reservation price for the network rights alone is a far more difficult task than estimating the producer's reservation price

for the package of both the network and the back-end rights. Since the producer's reservation price for the network rights is equal to the difference between the producer's total cost of production and the value that the producer currently places on the back-end rights, the original FISR required the network to estimate the value that the producer placed on the back-end rights to the program. That value would depend on (1) the producer's opinions as to the probability that the series will ever reach syndication; (2) the likely conditions in the off-network market four or five years hence; (3) the relative value of this series among those entering the off-network market at that time; and (4) the producer's access to financing and his willingness to bear risk, which would determine the rate at which the producer would discount those future amounts to arrive at a value today. Even the producer could only roughly estimate of the value of his back-end rights, and the network's estimate of the producer's estimate would be subject to even greater uncertainty.

50. Thus, under the original FISR, the network's estimate of the producer's reservation price for the network rights would vary over a wide range. The high end of that range would be the difference between (1) the network's estimate of the producer's estimate of the maximum likely program production costs and (2) the network's estimate of the producer's estimate of the minimum likely value of the back-end rights. The low end of the range would be the difference between (1) the network's estimate of the producer's estimate

of the minimum likely production costs and (2) the network's estimate of the producer's estimate of the maximum likely value of back-end rights. The greater the uncertainty as to the value of the back-end rights, the greater the uncertainty as to the producer's reservation price for the network rights, and the more likely it becomes that the only way that the network can be confident of successfully acquiring those rights (and ensuring the continued cooperation of the producer) will be by paying a network license fee that more closely approximates the cost of production.

51. Absent the original FISR, however, the network could structure the negotiations so as to pay the producer an amount that exceeds his reservation price only by whatever amount, if any, the network found it in its own interest to offer. Specifically, without any rules, the network would be free to insist that producers negotiate a single price for a package of both the network rights and (all or some percentage of) the back-end rights. As discussed above, the producer's reservation price for the package is the producer's estimate of the cost of production,7/ since this is the lowest price the producer will accept to produce a program rather than abandon the project. The network's reservation price for the package is the sum of the network's valuation of the network rights and the back-end rights. Given that the producer has far less

7/ The producer's cost of production is the total economic incremental cost of production, including the opportunity cost of the producer's continued involvement and a normal return on any costs not already sunk.

information than the network about the value of the network rights, and that the valuation of syndication rights is highly uncertain and subjective, producers cannot be expected to estimate the network's reservation price with any degree of accuracy. The networks, in contrast, can accurately estimate the producer's reservation price because program production costs are relatively well known in the industry and relatively easy to predict.8/

52. Abolishing the FISR, therefore, would place producers in a position where they must negotiate terms after they are locked-in to a particular network -- a network that can estimate with reasonable accuracy the minimum price that a producer would be willing to accept for the program rights.9/ Under the original FISR, in contrast, the networks were forced to negotiate over an asset whose reservation price to the producer could not be determined with any accuracy by the network, dramatically improving the producer's bargaining position.

8/ This is especially true given the ability to enter into multi-year contracts with input suppliers that constrain opportunistic behavior by those suppliers. Indeed, if necessary, the payments to producers can be tied directly to realized production costs through partial or complete cost-plus provisions, albeit at some loss of incentives to reduce those costs.

9/ Moreover, should there be any disagreement or doubt as to that amount, the network can force the producer to accept (in effect) a cost-plus contract. Such a contract would demote the producer, in terms of risk and reward, from owner to employee.

D. A Properly Structured Separate Negotiation Requirement Can Inhibit the Networks' Ability to Exercise Market Power in the Market for Syndicable Programming

53. When the Commission asked for comments on alternatives to the original FISR, the program producers stated that, if the existing rules were not preserved, they favored a mandatory separate negotiation, as recommended to the FCC by the Department of Commerce. Under the Commerce Department proposal, the networks would be permitted to acquire the back-end rights in programs, but would be barred from negotiating for those rights until after the network had committed to air and has scheduled the program. The producers were reluctantly willing to accept this proposal as the only hope, in the absence of the rules, of maintaining some countervailing bargaining power for the producers. This power, as discussed below, would inhibit the network's ability to engage in first-degree price discrimination. In addition, the Department of Commerce proposal would permit the networks to realize any unique efficiencies they have in financing program production by permitting them to acquire back-end rights.

54. The Commission adopted a separate negotiation safeguard, but imposed a short, 30-day waiting period, between negotiations. Unfortunately, this rule will not effectively prevent the networks from engaging in price discrimination by tying the acquisition of back-end rights to the acquisition of network rights. To illustrate this point: Suppose that a producer values the back-end rights to a program at

approximately $200,000 and that the producer's production costs, and thus his reservation price for the package of both network and back-end rights, is approximately $450,000. Under the original FISR, there would be truly separate negotiations for the network rights because the network could not acquire any back-end rights. And network uncertainty as to the producer's reservation price would allow the producer to negotiate a price -- say $300,000 -- for the network rights that exceeds his reservation price of $250,000.

55. If the network knows, however, that it will be allowed to purchase the back-end rights at some future time, it can reduce the network fee to a level where the producer -- if he retains the back-end rights or sells them to a third party -- cannot recover his full costs of production. For example, if the network reduces the network fee to $200,000, a thirty-day waiting period is of no help to the producer. Since the best offer for the back-end rights from third parties will be $200,000 (the market value of those rights), and the total the producer can obtain from selling those rights to a third party ($200,000 for the network rights plus $200,000 for the back-end rights) will be insufficient to cover his full costs of production of $450,000, the producer will be forced into negotiations over back-end rights with the network. The network can then offer him the seemingly generous amount of $250,000 for his back-end rights, just enough to cover the producer's costs of production. Considered in isolation, that price may seem to be more than reasonable, even generous; the

producer would be selling his back-end rights voluntarily to the "highest bidder." But the reality of this example is that the network has managed to tie the purchase of those back-end rights to access to its network, forcing the producer to surrender the network and back-end rights to the network for a price less than the competitive price. Allowing the network to bid on those rights has not increased the total amount paid to the producer for his program, but instead has reduced that amount by $50,000 (i.e., from $500,000 down to his reservation price of $450,000).

56. An effective separate negotiation safeguard requires that negotiations over back-end rights be delayed until the relative negotiating positions are more balanced. If the negotiation for back-end rights are delayed until the network has committed to air and has scheduled a program, the network will then have incurred large sunk costs in the program, and now both network and producer will have something to lose from a stalemate. In these circumstances, the network would likely pay more than the producer's reservation price for the back-end rights even though, having already acquired the network rights, the network knows with certainty the producer's reservation price for the back-end rights.

57. A truly separate negotiation requirement may also provide producers with some countervailing bargaining power during the negotiations for the network rights, especially when faced with a network strategy of attempting to low-ball network rights to force the producer to accept its subsequent offer for

the back-end rights. Returning to the numerical example above, if the network offers only $200,000 for the network rights, the producer risks the possibility that, after the network commits to air the program, the network will offer less than $250,000 for the back-end rights. If that were to occur, the producer would receive less than its reservation price. Thus, if offered only $200,000 for the network rights, the producer might choose to abandon the project. In order to ensure that this does not happen, the network would have to offer at least $250,000 for the network rights. Indeed, given the uncertainty involved in the network's task of estimating the producer's reservation price, the producer may receive considerably more than $250,000. In sum, a separate negotiation safeguard will inhibit the networks' ability to "extract" through price discrimination only if the negotiation for the back-end rights occurs, as the Department of Commerce recommended, after the network has committed to air and has scheduled the program.10/

58. While the major concern here is with the effect of eliminating the FISR on the ability of each network to exercise *ex post* market power, eliminating the FISR may also significantly enhance the ability of the networks to cooperate tacitly *ex ante* in the purchase of programs for network television -- *i.e.*, before the producer is locked in to a particular network.

10/ The networks' claim that producers will sell their back-end rights before this time is wrong for the reasons discussed at ¶¶ 20-22.

59. For the reasons discussed above, one mutually profitable cooperative arrangement among the networks would be to pay producers only the production costs of the program in exchange for both the network and the back-end rights, thus enabling each network to extract fully any excess profits earned by the program. (To encourage the producer's best efforts, it may be efficient for the producer to retain some share of the back-end rights. To the extent that this share is relatively small, this possibility will have little effect on the outcome described below.)

60. Since production costs can be estimated with reasonable accuracy, cheating by a network on this arrangement would be quickly detected because the broad details of network deals with producers -- particularly those that are expected to have more popular programs -- are routinely reported in the trade press. And punishment would be swift -- taking the form of simply matching the cheater's offers to producers. There would certainly be some ability to cheat on the agreement because production costs are not perfectly predictable. But because each of the networks engages in some in-house program production, each will have relatively good estimates of those costs and therefore the scope for cheating should be quite small. Thus, the three ingredients in the Merger Guidelines' recipe for successful "coordinated interaction" -- sometimes called tacit collusion -- are present here. Merger Guidelines at Section 2.1.

61. If the networks are prohibited from acquiring back-end rights -- or at least from acquiring them before they commit to air a particular program -- they might attempt to coordinate by paying license fees for each program equal to production costs less the expected syndication value of the program. If successful, this strategy would also extract any excess profits earned by the program. Detection of firms cheating on this arrangement, however, is far more difficult. As discussed above, expected syndication values appear to be far more uncertain than production costs. If one network offers producers a higher license fee than the other networks would have offered, the other networks will find it difficult to determine whether the higher license fee is simply the result of the greater and genuine uncertainty surrounding syndication values or instead is an attempt by the purchasing network to cheat on the agreement and curry favor with the producers. As the antitrust agencies note in their Merger Guidelines, because "deviations [from the agreement] may be relatively difficult to distinguish from these other sources of [license fee] fluctuations, . . . deviations may be relatively difficult to deter." Thus, under the FISR, the incentive for networks to cheat on a tacit agreement is significantly heightened, and the likelihood of successful coordinated interaction is reduced.

62. In general, it is much easier for firms to reach and maintain agreement on a few clear-cut rules than to coordinate on a myriad of individual prices. As an example,

consider how much easier it is for a significant number of real estate agencies in any given town to maintain a common 6% commission rate, as opposed to agreeing on the dollar amount of each commission for a very large number of transactions. Similarly, in this case, it is much easier to maintain a common policy of acquiring back-end rights than it is to agree on the individual prices to be paid for a large number of heterogeneous program rights.

II. THE FISR'S EFFECT ON EFFICIENT PROGRAM PRODUCTION AND THE NUMBER AND HETEROGENEITY OF PROGRAM PRODUCERS

A. The Effect of FISR on Efficient Program Production

63. As noted above, the networks argue that allowing them to bid on back-end rights, and thus "finance" program production, would result only in an increased number of bidders and heightened competition for those rights. The result, they claim, would be higher prices for those rights and financial gains to producers. Even assuming the networks lack the ability to engage in tying, whether their entry would result in higher payments to producers depends on whether there are network-specific efficiencies. In the absence of such efficiencies, program rights would be worth no more to the networks than to any of the numerous other potential buyers currently in the market, and permitting the networks to acquire back-end rights could not be expected to increase significantly the price of those rights.

64. Moreover, the producers would have every incentive to encourage the entry of the networks into the bidding for their back-end rights if, as the networks assert, significant network-specific efficiencies were likely and bidding were truly competitive, so that those efficiencies would be passed on to the producers. Yet, in this proceeding, the producers opposed the abolition of the financial interest and syndication rules. The Seventh Circuit suggests that only large, established producers (who fear network competition in program financing) opposed the repeal of FISR. This is incorrect. Small and emerging producers -- the very parties that the networks claim would benefit -- opposed repeal as well. This opposition is inconsistent with the hypothesis that the networks are uniquely efficient financiers. It is thus not surprising, therefore, that the available empirical analysis does not support the existence of network-specific efficiencies. <u>See</u> Attachment B.

65. The networks' opposition to the Department of Commerce's proposed separate negotiation safeguard is also inconsistent with their claims that they are uniquely efficient in financing programming. The safeguard would permit them to acquire back-end rights in programs. If the networks' efficiencies would truly result in their paying a higher price for such rights, program producers would wait and sell these rights to the networks after the waiting period expired. The networks' opposition to this proposal is inconsistent with the

hypothesis that the networks are attempting to repeal the FISR simply in order to achieve efficiencies.

66. The program producers would be the prime beneficiaries if there were any efficiencies resulting from network ownership of the back-end rights, and would thus have the greatest incentive to devise a way of structuring network participation so as to allow those efficiencies without exposing themselves to the threat of monopsonistic exploitation by the networks. Yet the producers strongly believe that the thirty-day waiting period adopted by the FCC is totally inadequate to provide the requisite protection, and continue to urge a post-commitment rule. This is the strongest possible evidence that the Commission needs to strengthen its safeguard in order to prevent the networks from extracting profits from the producers by engaging in first-degree price discrimination.

B. The Effect of the FISR on the Number and Heterogeneity of Program Producers

67. If the FISR is eliminated or replaced by a rule that would not be effective in inhibiting first-degree price discrimination, the result will be a reduction in the number and heterogeneity of producers. It is important to recognize the implications of two rather obvious facts: that "new" or "entering" or "fledgling" producers do not know with certainty how successful they will be in their career as a producer, and that entry involves some sunk costs -- the value of that individual's time, learning costs, or other opportunities foregone.

68. Given these two conditions, it follows that, in deciding whether to become a producer, the individual must consider both the probabilities of different degrees of success (e.g., very successful, moderately successful, unsuccessful) and what he could expect to earn at each degree of success. No potential producer would enter if he believed he would forever be a "fledgling", or if he were certain that he would always be unsuccessful. Given sunk costs and uncertainty, the decision to become a producer is a function of the returns to all possible degrees of success over the lifecycle of his career from fledgling to established veteran. The best indicator of the economic return he could expect for any given degree of success is the return currently being earned by producers of that level of success. Thus, absent special information as to one's prospects, the entrant's best estimate of his likely future earnings is the average earnings of current producers.

69. The rate of entry into program production, and the total number of producers, are thus determined not just by the cost of entry or by the net income of the average "fledgling" producer. As long as an entrant believes that he or she may one day become a "successful" producer, anything that increases the incomes of "successful" producers will encourage entry. Moreover, entry would still be encouraged even if, at the same time, the return to being a "fledgling" producer fell. (Indeed, an increase in the return to being very successful -- for example, establishing

a Nobel Prize for producers -- would, by encouraging entry, reduce the expected net earnings of new entrants and indeed reduce the average expected earnings of all those who turn out never to receive the Nobel Prize for television production). This has several obvious implications for the effect of repealing the FISR which the networks appear to deny or ignore.

70. First, even if eliminating the FISR were to reduce the earnings only of "successful" or "established" producers, an ancillary effect would be to discourage the entry of new producers and reduce the equilibrium stock of producers, thus reducing the diversity of the sources of programming.11/ Thus, the usual efficiency (though not equity) defense of first-degree price discrimination under certainty (that it results just in a transfer of wealth and does not affect output) is absent in this instance: first-degree price discrimination by networks against producers *ex post* reduces the expected return to producers *ex ante*, and acts as a deterrent or barrier to entry, reducing the rate of entry and the equilibrium level of producers.

71. Second, the effect on entrants of eliminating the FISR would not be uniform: the greatest effect would be on inhibiting entry by potential producers who are

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11/ As a stark analogy, consider the effect of a 90% tax on lottery earnings. A winning ticket would still be worth buying, and if someone were certain of winning, it would still make sense to buy a ticket. But the number of tickets sold for any given prize would fall by (roughly) the percentage tax rate.